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ABSTRACT

The effects of tax deductibility on American education are discussed in this report, which is based on the premise that alteration by the Federal Government of the deduction for state and local taxes will exacerbate taxpayer resistance and increase cuts in public services, ultimately undercutting public support for education. The discussion offers the following assertions: (1) any restriction of income tax deduction reduces a major source of state revenue for education; (2) curtailing the property tax deduction increases tax resistance and may precipitate tax revolts, leading to a backlash against school spending; (3) income tax deductions affect higher education, which is largely funded at the state level; and (4) restrictions on income or property tax deductions would disproportionately penalize various states. The conclusion is that all states will be adversely affected in some way over the long run. Nine tables and two figures are included. (LMI)

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Maintaining the Federal Government's Commitment to Education: The Case for Preserving the Deduction for State and Local Income and Property Taxes

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September 27, 1990

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I. Introduction: The Importance of Tax Deductibility To Education

As the budget negotiations continue, deductibility of state and local taxes is once again on the table. Reports indicate that a centerpiece of one proposal is a limit on the state and local income tax deduction; earlier reports have indicated that the property tax deduction is also threatened.[1]

Any such proposed limitation of the state and local tax deduction must be seen in the context of the relentless cuts in federal support for education that have occurred over the past decade. As the federal government has reduced its support, localities and especially the states have had to take up the slack by increasing a variety of state and local taxes and fees.

The significance of federal tax deductibility to American education is painfully direct. Today deductibility of state and local taxes helps to cushion the impact of those taxes. For taxpayers in the 28% federal tax bracket, for example, deductibility means that the total burden of income and property taxes is reduced by 28%; for the taxpayers in the 33% tax bracket, the cushion is correspondingly greater.

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[1] See e.g. the letter from House Ways and Means Committee Member Don Pease to House Speaker Thomas S. Foley, proposing new limits on the complete state and local deduction and other deductions, June 11, 1990.

Eliminating or limiting deductibility will increase the burden of these taxes on taxpayers. While the states will differ in the timing and intensity of their taxpayers' responses, the increased burden of state and local taxes will increase taxpayer resistance to maintaining current state and local tax levels. In turn, that will place pressure on states and localities to reduce spending on services.

Curtailing deductibility today would be especially disruptive because:

- The national and international economies require more from our school children, high school graduates, and college and university graduates than ever before; repeated studies show that proficiency of American students lags behind that of foreign competitors.

- The federal government has substantially reduced support for education; to the extent the federal government now curtails deductibility, it will undercut the ability of states and localities to fund the increased support needed because of the federal withdrawal.

- States and localities are especially vulnerable now to any restrictions on deductibility. Voters in many states object to the increased burden of income and especially property taxes needed to fund the increasing state and local share of education and other public services.

  -- Tax or spending limits are on the November ballot in at least ten states: California, Colorado, Louisiana, Massachusetts, Montana, Nebraska, Nevada, Oregon, South Dakota, and Utah.

-- As many states go into recession, they face revenue shortfalls that will compel service cutbacks. Cuts in education spending, that historically have been disproportionately high at times, place state and local schools, colleges and universities under special stress.

Education is the single largest category of state and local spending, amounting to about one-third of total state and local budgets. State and localities spend as much on education as they do for the combined budgets of the next four categories of public services: health care, welfare, highways and police. If states and localities are pressured to reduce services, education bears the brunt because it makes up such a large part of the budget.

There is ample historical precedent that shows the consequences for education when voters object to tax burdens and insist on cutting state and local spending. The tax revolts in Massachusetts following Proposition 2 1/2 and in California after Proposition 13, greatly harmed schools. While school budgets constituted about half of local spending in Massachusetts, these budgets were cut the year following Proposition 2 1/2 by 160% of the average cut for all spending. In California, the state dropped from 22nd to 31st in the country in expenditures per pupil, employed teachers who had not specialized in science and math to

teach those courses, eliminated some of those courses and curtailed honors and advanced placement programs.

To the extent that the Federal Government tampers with the deduction for state and local taxes, and to the extent this leads to taxpayer resistance and cuts in public services, education will feel the consequences.

This report focuses on several key aspects of education finance:

- First, states now provide a greater proportion of funding than localities for primary and secondary education. Because the states rely heavily on income taxes, and not on property taxes, any restriction of income tax deductibility would directly affect a major source of funding for primary and secondary education. Moreover, many local school systems that rely on local income taxes would be directly harmed by restrictions on deductibility.

- Second, localities rely predominantly on property taxes to fund their share of elementary and secondary education. The property tax is the least popular of all taxes. Curtailing deductibility can precipitate tax resistance and even tax revolts that require cuts in school spending.

- Third, higher education, which is largely funded at the state rather than the local level, would be directly affected by any changes in income tax deductibility.

- Fourth, because states have developed individualized tax and school funding systems, restrictions on income tax deductibility or property tax deductibility or both would disproportionately hurt various states for no rational reason.

If implemented, proposed restrictions of deductibility promise to make education funding more difficult for states and localities. Some problems will begin immediately, as federal tax change forces some states and localities away from reliance upon the taxes whose deductibility has been constricted, and toward greater reliance upon taxes or taxpayers whose taxes remain fully deductible. By targeting deductibility in a piece-meal fashion, the federal government transforms the remaining taxes into federally favored revenue sources for education and other public services. Thus, significantly, property taxes -- whose disparities across school districts have long been the bane of education finance -- would become a federally encouraged source of school funding, if they remain fully deductible from federal income taxes. By contrast, state and local income taxes, often a progressive source of revenue, may be transformed into a federally disfavored revenue source for education and other public services if their deductibility is curtailed. As noted above, curtailing property tax deductibility merely compounds the problem by increasing fiscal disparities between rich and poor school districts.

Such changes also promise to increase the long-term difficulty of education funding. At a time of

continuing cutbacks in federal support for public schools, curtailing deductibility now will strain the ability of states and localities to fund education themselves. Some states, depending on their degree of reliance on income and property taxes, may be hit much harder than others in the short run; all states are affected over the long run because of the way that cuts in deductibility may preclude reliance on income or property taxes in the future.

II. Federal Cutbacks in Education Support Have Made State and Local Support for Education Especially Vulnerable to Harm From Restrictions on Deductibility

A. Reductions in Federal Support for Education in the 1980's

Despite clear evidence of the need to improve our nation's schools, the federal government has contributed rhetoric rather than tangible support. Indeed, over the 1980's, the federal government has reduced spending on the education of America's children. Consider the following statistics:

- The federal share of spending for elementary and secondary education fell from 9.2% in FY 1981 to 6.3% in FY 1988
- Federal spending for elementary and secondary education fell by almost 17 percent; federal spending for higher education fell by 27 percent between FY 1980 and FY 1989 (in constant dollars). (See Table 1, on p. 8).
- Federal tax support (so-called tax expenditures) for education fell from $20.4 billion in FY 1980 to $16.4 billion in 1988 (again, in constant FY 1989 dollars). (See Table 2, on p. 9).

All of these statistics are based on U.S. Department of Education reports.

It is worth recounting once again that the 1990's are a time when America should be strengthening rather than

Table 1

Cutbacks in Federal Education Funds
1980-89, in Constant (FY 1989) Dollars
(Millions of Dollars)

	Elementary and Secondary Education Funds	Post-Secondary Education Funds
1980	$23,890.8	$16,306.4
1989 (est.)	19,843.1	11,904.2
Percentage Change	- 16.9%	- 27.0%

Source: U.S.Department of Education, Digest of Education Statistics, 1989, Table 302, p. 334.

Table 2

Cuts in Federal Tax Expenditures for Education, 1980-1988, in Constant (FY 1989) Dollars (Estimated)
(Millions of Dollars)

1980	$20,376.4
1988	16,428.0
Percentage Change	-19.4%

Source: U.S.Department of Education, Digest of Education Statistics, 1989, Table 302, p. 334.

reducing support for educating our children. Consider these important indicators of the need to improve school performance of many students:

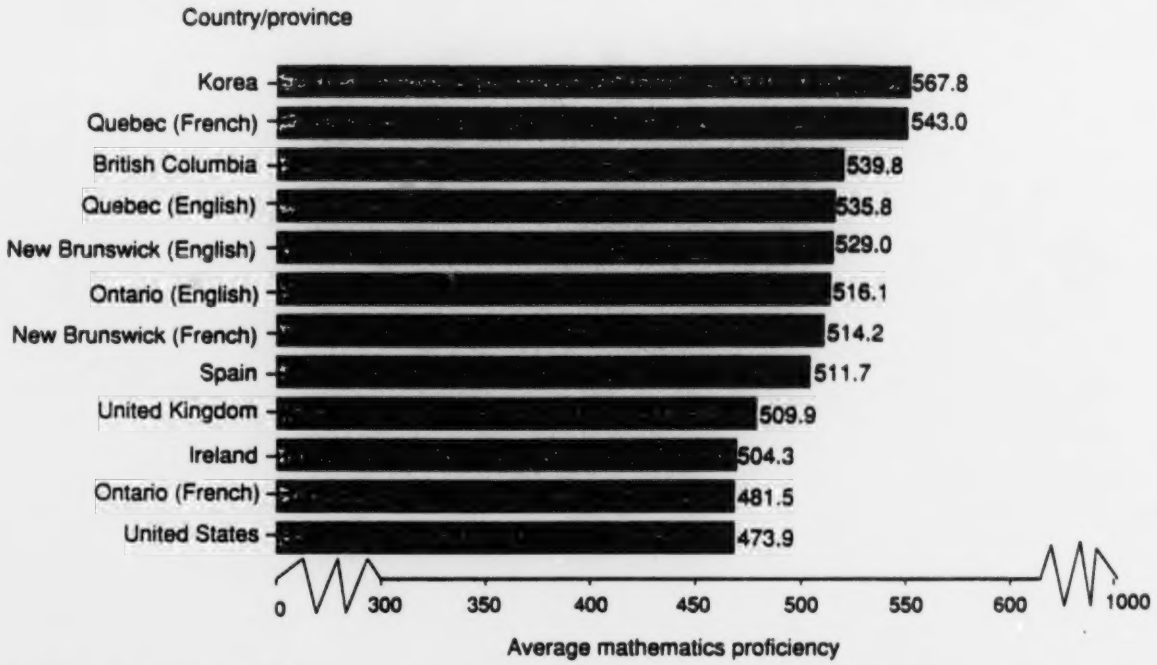
- In an analysis of international mathematics testing for the most advanced 12th-grade mathematics students, U.S. students ranked next-to-last among the 13 participating nations. The best scores were made by Japanese students, who had the highest average scores on each of the three parts of the test, algebra, geometry, and calculus. The Japanese schools were also among the most likely to cover the material that was tested on the exam. The American schools covered the smallest portion of the material, with the exception of schools in British Columbia.

- In the 1988 International Assessment of Educational Progress, the U.S. 13-year-olds scored lowest in mathematics and in the bottom third on science achievement among a group of countries and Canadian provinces.

- In a series of science tests administered to a selected group of countries between 1983 and 1986, the U.S. 14-year-olds scored somewhat lower than their peers in 12 other countries, better than 2 other countries, and about the same as Singapore and Thailand.

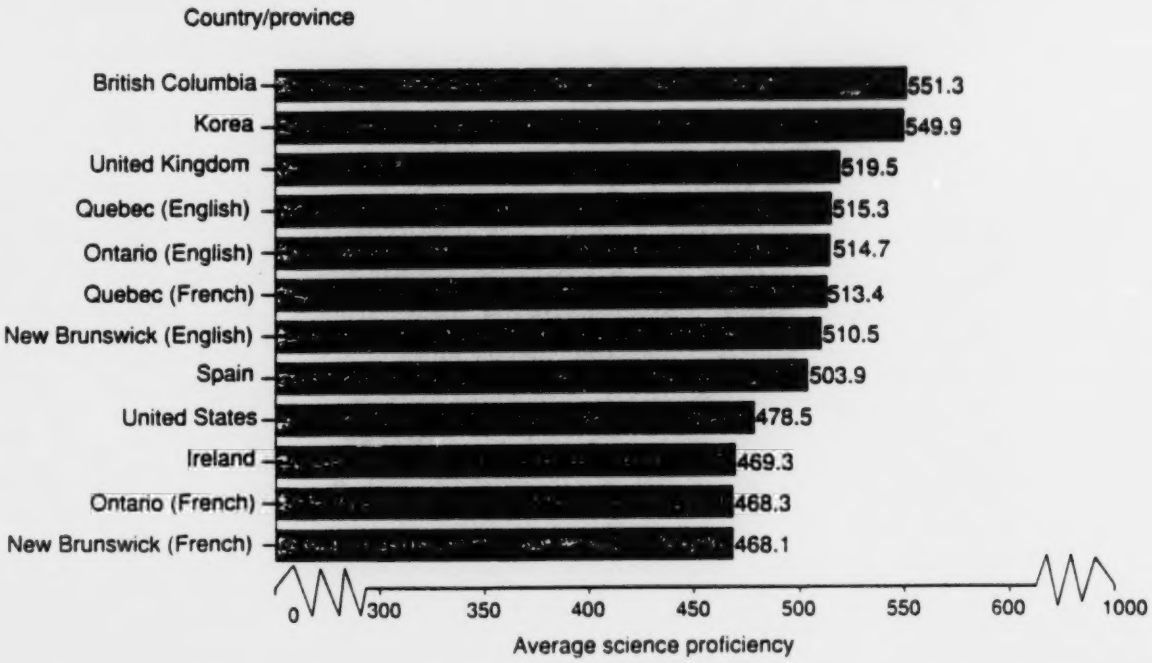
The latter two results are depicted in Figures I and II, on p. 11, prepared by the U.S. Department of Education. Failure to educate our children properly is having direct and measurable consequences for our national standing as a competitor in the global economy.

Figure I —Mathematics proficiency at age 13, by country/province: 1988



SOURCE: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress, *A World of Differences*, by Educational Testing Service.

Figure II —Science proficiency at age 13, by country/province: 1988



SOURCE: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress, *A World of Differences*, by Educational Testing Service.

B. Increased State and Local Support for Education and Voter Resistance

As the federal government has withdrawn its support for education, states and localities have taken up the burden. At the beginning of the decade, in fiscal year 1981, the federal government provided 9.2% of spending for elementary and secondary schools; states provided 47.4% and localities 43.4%. By FY 1988, the latest year for which statistics were available for this report, the federal share declined to 6.3% while the state share and local share rose to 49.5% and 44.1% respectively.[2]

Voters have objected to the higher tax burdens resulting from increased state and local support for education and other public services increasingly neglected by the federal government. Twenty states already have constitutional or statutory limits on taxes or spending or both, and taxpayer resentment continues to fuel such measures.

In 1990, new tax and spending limit proposals have been certified for the ballot in ten states: California, Colorado, Louisiana, Massachusetts, Nebraska, Nevada, Oregon, South Dakota, and Utah. In Oklahoma, two ballot measures have enough signatures but face court challenges.

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[2] U.S. Department of Education, Digest of Education Statistics 1989, Table 138, p. 148, and Common Core of Data Survey, Table 148, December 1989.

Ballot measures in the majority of these states fall into three categories. Initiatives in California and Oklahoma would amend the respective state constitutions to require a "supermajority" vote in the legislature for any tax increases not approved by the voters. Initiatives in Massachusetts, Nebraska, and Oklahoma would repeal tax increases already approved by the legislature. Initiatives in Colorado, Oregon, and South Dakota seek to cap or roll back property tax revenues or assessments.

On other fiscal matters, Nevada voters will be asked to approve a constitutional amendment to prohibit a personal income tax, while Utah will decide whether to exempt food from the state sales tax. Montana voters will decide whether to replace all property, income, and excise taxes with a one percent "transaction fee."

In two of the states, education spending is directly targeted. The Nebraska measure would repeal the 1990 tax increase for education finance reform. The Oklahoma initiatives similarly would repeal education-related tax increases. The Oregon measure would limit property taxes for schools and general government, but would require the state to make up lost revenue due to the new property tax limit.[3]

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[3] Scott Mackey, "Tax and Spending Limitations on the November Ballot," National Conference of State Legislatures, September 1990.

Curtailing deductibility of state and local taxes will increase such taxpayer resentment in many states and localities by increasing the effective burden of those taxes. The federal government has chosen the wrong time to attack the revenue sources of states and localities and their continuing ability to fund the current level of school quality, plus additional levels of academic excellence that all agree are necessary in today's internationally competitive world.

III. Capping the Income Tax Deduction Arbitrarily Hurts States That Are Doing Most to Fund Education

One proposal under consideration would limit the income tax deduction. In the most recent version, limits on deductibility would be set for taxpayers earning above $200,000, thereby eliminating over one quarter of the total value of the state and local income tax deduction.

The accounting firm of Ernst & Young has attempted to determine the states most affected by this proposal. Preliminary evidence indicates that the following states are the fifteen whose taxpayers are most affected.

Table 3

States Whose Taxpayers are Hardest Hit By Capping Income Tax Deductibility

California
Maryland
New York
Virginia
Utah
Minnesota
Hawaii
Arizona
Colorado
New Jersey
Georgia
Delaware
Massachusetts
Oregon
Michigan

The states are ranked by the amount lost under the proposal, as a fraction of total federal income taxes paid, to give a relative measure of the severity of the impact on the states' taxpayers. The figures are based on preliminary 1988 information provided by the IRS.

Many of these states fund a large part of elementary and secondary education at the state level -- Hawaii (99.9%), California (75.7%), Delaware (74.1%), Georgia (61.6%), Utah (59.5%), and Minnesota (58.3%). (See Table 1. p. 8, above) Deductibility will have direct effects on statewide budgets and education is most likely to be affected in such states.

These 15 hardest hit states tend to include many that are making above-average efforts to support education. Ten of the fifteen states are above average in spending per pupil. Those states (and their national ranking in 1989) are: New Jersey (1), New York (2), Massachusetts (7), Delaware (9), Maryland (11), Oregon (15), Virginia (16), Colorado (17), Minnesota (18), and Michigan (19).[4] Curtailing deductibility under this particular proposal will have the ironic result of penalizing many states that are trying to fund high quality school systems.

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[4] U.S. Bureau of the Census, Statistical Abstract of the United States 1990, Table 236, p. 144.

For many other states, the adverse effects will be generally uncorrelated with the greater or lesser extent that they are making special efforts to support education. ~~Plus,~~ Further a cap on income tax deductibility will have virtually no effect on taxpayers in the ten states that have no income tax or only a limited income tax (usually on interest and dividends only).

Table 4

States Without Individual Income Taxes

Alaska
Connecticut
Florida
Nevada
New Hampshire
South Dakota
Tennessee
Texas
Washington
Wyoming

Many of these states rely on various forms of exported taxes, such as energy severance taxes and taxes paid by tourists, to shift tax burdens to non-residents. Just over half of these states -- (Alaska, Connecticut, Florida, New Hampshire, Washington and Wyoming) -- provide above-average spending, in dollars per pupil, for elementary and secondary schooling; the other states are below average

on this measure. There is no sensible correlation between the education effort made by these states and the fact that they would be spared the consequences of restrictions on income tax deductibility. Other proposals to limit deductibility promise to be equally unpredictable and harmful to states' efforts to fund education.

Curtailing deductibility presents federal policy-making at its most capricious. States would be arbitrarily penalized for funding education and other services on the basis of the mix of taxes reflecting traditions and preference of their taxpayers. The federal government would curtail deductibility and impose financial penalties without regard to the fiscal capacity of a state or the quality of its schools and other services. The only non-arbitary aspect of an attack on tax deductibility is its effect on states and localities that have worked to increase income and property taxes to pay for high quality schools. By attacking the ability of states and localities to rely on their own tax bases, curtailment of deductibility can precipitate cuts in school funding at a time when America's schools need to be strengthened.

Just as each state's educational system will be affected in a unique manner by the multibillion dollar pressures of any reductions in deductibility, so will school districts and governments in each state be forced to make

hard choices about the way school funding must be changed to respond to the new pressures. It is hard to believe that the federal government that repeatedly exhorts states and localities to greater educational efforts is the same government now proposing to weaken school funding by attacking deductibility.

IV The Importance of Tax Deductibility to Elementary and Secondary Education

A. The Consequences of Cutting the Income Tax Deduction

Contrary to popular belief, America's schools in 1990 rely primarily on statewide rather than local funding for most of their support. In earlier years, elementary and secondary schooling was funded largely at the local level through real property taxes. This resulted in significant disparities between wealthy areas with large property tax bases and less well-off districts with lower fiscal capacities. Within the same state, some school districts may have assessed property valuations per pupil that are ten or twenty times greater than others. Since the 1960's, property tax disparities have spawned considerable litigation, much of it successful, on behalf of less fortunate school districts.

Because of concern about these fiscal disparities, the states have taken up an increasing share of the funding of primary and secondary education, thereby helping to equalize the funds available to school districts across the state.

Setting aside the small (and diminishing) federal share of school funding (6.3% of the total), 53% of all state and local spending for elementary and secondary

education comes from the state level, while only 47% comes from local taxes. Table 5 (pp. 22-23, below) presents a state-by-state breakdown of the state versus local share of support for elementary and secondary education among the states. Indeed, four states provide 75% or more of their school funding from statewide taxes: Hawaii (99.9%), New Mexico (85.9%), Washington (80.2%), and California (75.7%). By contrast, the only two states in the Union providing less than 25% of elementary and secondary school funding are New Hampshire (7.9%) and Nebraska (23.9%).

Many states, of course, rely on personal income taxes as a major source of revenue (Table 6, pp. 24-25, below). Indeed, as is seen in Table 7, on page 26, voters view the state income tax as much more fair than other kinds of taxes, notably including the federal income tax and local property taxes. In 1989, states relied upon individual income taxes to raise $88.7 billion in revenues, or over 31% of total state tax receipts.

Many cities, counties and school districts also rely on individual income taxes, as can be seen in Table 8, on page 27. If federal policy makers reduce or eliminate income tax deductibility, this will have several consequences. First, if income taxes alone are targeted, then the federal government will effectively establish the

Table 5

State and Local Revenues for Primary and Secondary Schools: The Proportions Provided By States and Localities, 1987-88

	Total (Million)	Percentage Financed By: State	Localities
U.S. Average	$158,931	52.9%	47.1%
Alabama	1,915	73.0	27.0
Alaska	690	71.3	28.7
Arizona	2,175	50.6	49.4
Arkansas	1,078	63.3	36.7
California	16,572	75.7	24.3
Colorado	2,316	41.2	58.8
Connecticut	2,785	43.8	56.2
Delaware	429	74.1	25.9
Florida	6,969	58.9	41.1
Georgia	3,443	61.6	38.4
Hawaii	541	99.9	0.1
Idaho	530	69.7	30.3
Illinois	6,114	38.9	61.1
Indiana	3,639	58.9	41.1
Iowa	1,857	49.9	50.1
Kansas	1,686	45.4	54.6
Kentucky	1,607	73.8	26.2
Louisiana	2,258	62.3	37.7
Maine	834	55.0	45.0
Maryland	3,291	40.7	59.3
Massachusetts	4,287	44.2	55.8
Michigan	7,218	37.4	62.6
Minnesota	3,159	58.3	41.7
Mississippi	1,023	72.8	27.2
Missouri	2,890	43.2	56.8
Montana	586	51.5	48.5
Nebraska	959	23.9	76.1
Nevada	635	40.2	59.8
New Hampshire	724	7.9	92.1
New Jersey	6,958	44.3	55.7

Table 5 (cont'd)

	Total (Million)	Percentage Financed By: State	Localities
New Mexico	910	85.9	14.1
New York	16,320	45.4	54.6
North Carolina	3,503	72.2	27.8
North Dakota	395	56.4	43.6
Ohio	6,273	51.1	48.9
Oklahoma	1,646	70.0	30.0
Oregon	1,810	29.7	70.3
Pennsylvania	8,320	48.4	51.6
Rhode Island	652	45.8	54.2
South Carolina	1,991	59.5	40.5
South Dakota	387	29.6	70.4
Tennessee	2,000	49.7	50.3
Texas	11,635	47.9	52.1
Utah	1,110	59.5	40.5
Vermont	472	34.9	65.1
Virginia	N/A	N/A	N/A
Washington	3,026	80.2	19.8
West Virginia	1,165	73.2	26.8
Wisconsin	3,398	43.1	56.9
Wyoming	546	51.2	48.8

Source: U.S. Department of Education, National Center for Education Statistics, December 1989. This table excludes the support to education from federal sources, averaging 6.3% of total government spending in 1987-88; the state and local percentages add to 100% in each case.

Table 6

Percentage Reliance on Different Deductible Taxes by States and Localities in FY 1987

State	Property	Individual Income
U.S. Average	59.2	40.8
Alabama	35.1	64.9
Alaska	99.9	0.1
Arizona	67.5	32.5
Arkansas	46.7	53.3
California	49.7	50.3
Colorado	64.6	35.4
Connecticut	85.3	14.7
Delaware	29.1	70.9
Florida	100.0	--
Georgia	50.1	49.9
Hawaii	38.9	61 1
Idaho	55.7	44.3
Illinois	68.1	31.9
Indiana	59.2	40.8
Iowa	63.2	36.8
Kansas	68.7	31.3
Kentucky	39.5	60.5
Louisiana	66.8	33.2
Maine	59.8	40.2
Maryland	39.9	60.1
Massachusetts	48.5	51.5
Michigan	63.3	36.7
Minnesota	51.3	48.7
Mississippi	66.1	33.9
Missouri	49.4	50.6
Montana	73.3	26.7
Nebraska	73.8	26.2
Nevada	100.0	--
New Hampshire	99.1	0.9
New Jersey	71.4	28.6

Table 6 (cont'd)

	Property	Individual Income
New Mexico	48.6	51.4
New York	49.3	50.7
North Carolina	42.1	57.9
North Dakota	77.2	22.8
Ohio	48.7	51.3
Oklahoma	54.2	45.8
Oregon	57.1	42.9
Pennsylvania	53.2	46.8
Rhode Island	64.2	35.8
South Carolina	49.4	50.6
South Dakota	100.0	--
Tennessee	94.7	5.3
Texas	100.0	--
Utah	55.4	44.6
Vermont	68.5	31.5
Virginia	50.9	49.1
Washington	100.0	--
West Virginia	45.9	54.1
Wisconsin	57.1	42.9
Wyoming	100.0	--

Source: ACIR, Significant Features of Fiscal Federalism, 1989 Edition, Volume II, Table 30, pp. 48-49.

NOTE: ACIR and census figures fail to separate individual from corporate property taxes; that means reliance on individual income taxes is somewhat understated in this Table.

Table 7

1989

Which Do You Think Is the Worst Tax—That Is, the Least Fair?

(in percent)

1. Federal income tax
2. State income tax
3. State sales tax
4. Local property tax
5. Don't know/No answer

	1	2	3	4	5
Total Public	27	10	18	32	13
Male	29	9	18	33	11
Female	25	10	19	32	14
Head of Household	28	9	19	33	11
Male Head	29	9	19	33	10
Female Head	27	9	20	32	12
Under 35 Years of Age	26	12	18	32	12
18-24	23	11	13	35	18
25-34	28	12	20	31	9
35-44	36	12	18	27	7
45-65	24	8	21	34	13
Over 65	25	4	15	36	20
High School Incomplete	17	7	21	34	21
High School Graduate	26	10	17	35	12
College Incomplete	36	13	15	29	7
College Graduate	32	9	21	30	8
Household Income: Under $15K	19	8	21	35	17
$15-24.9K	26	12	20	34	8
$25K +	32	10	16	32	10
$25-29.9K	29	2	20	35	14
$30-39.9K	30	17	13	33	7
$40K +	34	9	17	30	10
Own	27	10	16	35	12
Rent	30	9	27	23	11
White	27	10	17	33	13
Nonwhite	30	5	24	30	11
Employed	30	11	18	31	10
Employed Female	31	13	16	29	11
Not employed	22	7	19	36	16
Not Employed Female	20	7	22	35	16
Professional, Manager, Owner	31	14	20	27	8
White Collar, Sales, Clerical	27	14	13	33	13
Blue Collar	29	9	18	32	12
Retired	27	4	21	35	13
Married	30	9	17	34	10
Not Married	23	10	20	30	17
Household Size: 1-2 People	27	9	19	33	12
3-4 People	28	10	18	29	15
5+ People	37	—	16	44	3
Children in Household: Under 18	27	12	16	35	10
No Children	28	7	20	30	15
Northeast	20	11	24	40	5
North-Central	28	9	13	36	14
South	31	8	18	30	13
West	28	11	19	23	19
Nonmetro	26	6	16	36	16
Metro: 50,000 and Over					
Fringe	30	11	19	29	11
Central City	26	13	20	32	9

— represents zero

Table 8

Localities Rely on Income Taxes, Too
Number of Jurisdictions with
An Individual Income Tax

State	1989
Alabama	
Cities	11
Delaware	
Cities (Wilmington)	1
Indiana	
Counties	79
Iowa	
School Districts	52
Kentucky	
Cities	84
Counties	26
Maryland	
Counties	24
Michigan	
Cities	19
Missouri	
Cities (Kansas City & St. Louis)	2
New York	
Cities (New York City & Yonkers)	2
Ohio	
Cities	492
School Districts	5
Pennsylvania	
Cities, Boroughs, Towns, Townships, and School Districts	2,795
Total (excluding Pennsylvania)	797
Total (including Pennsylvania)	3,592

Source: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, Volume I, Table 20, p. 57 (January 1990)

property tax as the primary source of revenue to be encouraged by federal tax policy. This result is easy to understand. Elimination of income tax deductibility increases taxpayers' out-of-pocket costs for state and local income taxes. Taxpayer resistance to income taxes inevitably will increase. By contrast, taxpayers do not perceive a change in property tax burdens if that deduction is preserved.

Economists observe that three results are likely. First, pressure on the income tax will cause states to look for alternative sources of revenue. Those other revenues can be raised from sales taxes and from user fees. Both of these are much less progressive than the income tax and the result will be to reduce the progressivity of state and local tax structures.[5]

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[5] Even though sales taxes are no longer deductible from federal income taxes, many states do use them to fund public services generally and education in particular. Because sales taxes are regressive, their burden falls heavily on low and middle income taxpayers who don't itemize federal taxes, and whose tax burdens have traditionally raised less political opposition than the objections of homeowners to property taxes, for example.

Also, many of the high-sales tax jurisdictions -- Hawaii, Florida, Louisiana, Nevada, and the District of Columbia, for example -- are unusually favored by tourism that enables them to shift much of the burden to non-resident visitors. This helps to reduce the burdens on in-state residents and minimize objections to high sales tax rates. Thus, when sales tax deductibility was eliminated in 1986, states and localities generally did not feel the impact that would result if income tax deductibility and (especially) property tax deductibility were eliminated.

Second, this new pressure on the income tax will force states to move away from statewide tax support. This is contrary to 15 years of progress toward greater statewide school funding to equalize the quality of education across each state. Increased reliance on property taxes would mean that states without equalization programs could return to the kind of school funding disparities prevalent before states increased the use of statewide taxes to support schools. People in school districts without highly valued taxable properties would again be forced to pay considerable taxes on their homes, in return for below-average quality schools.

This chain of events linking state revenue shortfalls to local budget cuts is now being demonstrated in the state of Virginia. Governor Douglas Wilder has announced that the state faces a $1.4 billion revenue shortfall, His proposed budget cuts include $333 million -- 24% of total state cuts -- to be taken from state aid to localities. Education, that receives over 47% of Virginia local budget spending, is likely to take much of the hit. This comes on top of the disproportionate cutbacks that education will suffer at the state level when state education programs are also curtailed.[6]

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[6] The Washington Post reports that "education accounts for 41 percent of all state spending but is responsible for (footnote continued)

Third, any increase in property tax burdens to fund schools could well contribute to popular resistance to taxes, such as occurred in California, Massachusetts and elsewhere in the country where property tax limitation measures have been voted. Voter resistance to property taxes means that localities may be limited in their ability to compensate for education funding lost by shifts away from the income tax if deductibility is cut or lost. In a state such as Oregon, with a property tax limit proposal on the 1990 ballot, loss of income tax deductibility could spark similar opposition to the proposed income tax increases that would be needed to make up the property tax shortfall.

The states will differ in the speed of their adjustment to the multibillion dollar tax changes, just as the states differ in their tax structures and in the sensitivity of their voters to changes in the mix of taxes and tax burdens. In some states, curtailing income tax deductibility could have immediate impact as government leaders try to anticipate voter reaction. In others, the effects may be delayed until voter reactions are felt at the polling place. Whether the reaction is immediate or more protracted, federal tax policy, if it discourages individual income taxes, will be undercutting the accomplishment of quality education based

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48 percent of [Governor] Wilder's cuts." "$1.4 Billion In Cuts For Virginia Detailed," Washington Post, September 14, 1990, p. A-1.

hand, curtailing deductibility of income and property taxes will fuel tax resistance to both taxes, weakening the ability of states and localities to fund schools. In both cases, schools may be threatened by budget cuts.

C. The Disproportionate Effects on Education of Cutting Tax Deductibility

If states and localities cut their services, education could suffer disproportionately. First education is by far the largest single category of state and local spending, amounting to one-third of all state and local government expenditures. The percent of spending on education, state-by-state, is shown in Table 9 (pp. 33-34 below). Two states spend over 40% of their combined state and local budgets on education: North Carolina (41.7%) and Utah (40.2%). The disproportionate size of education budgets in most states makes them vulnerable if states and localities must cut public services.

Each year, hundreds of school budgets come before the voters for approval of increased taxes or bonds. Often elections are close; only a minority of people have children in public schools at any one time, and other people are naturally less interested in funding quality schools. To the extent it forces increased reliance on property taxes that the voters do not like anyway, curtailing deductibility will make schools particularly vulnerable to pressure for

Table 9

Percentage of State-Local Spending
Going to Education by State, 1986-87

State	Education (All Levels)
U.S. Average	33.1%
Alabama	32.8
Alaska	22.6
Arizona	37.1
Arkansas	38.5
California	30.3
Colorado	35.8
Connecticut	28.7
Delaware	35.4
Florida	30.1
Georgia	33.9
Hawaii	26.3
Idaho	37.7
Illinois	32.2
Indiana	39.7
Iowa	37.9
Kansas	37.8
Kentucky	31.9
Louisiana	29.3
Maine	33.2
Maryland	32.4
Massachusetts	26.9
Michigan	36.4
Minnesota	33.1
Mississippi	34.5
Missouri	37.1
Montana	35.2
Nebraska	38.5
Nevada	27.6
New Hampshire	35.0
New Jersey	31.7

Table 9 (cont'd)

State	Education (All Levels)
New Mexico	36.1
New York	27.5
North Carolina	41.7
North Dakota	36.1
Ohio	35.8
Oklahoma	36.9
Oregon	36.8
Pennsylvania	32.4
Rhode Island	28.6
South Carolina	39.4
South Dakota	31.5
Tennessee	30.9
Texas	39.7
Utah	40.2
Vermont	37.5
Virginia	37.7
Washington	35.2
West Virginia	35.5
Wisconsin	35.9
Wyoming	35.8

Source: ACIR, Significant Features of Fiscal Federalism, 1989 Edition, Volume II, Table 52, pp. 86-87.

cutbacks. Such cutbacks would be especially disruptive at a time of increased calls for improved educational excellence.

Education tends to be hard hit when public services must be cut.[6] Consider the effects on California's education system when Proposition 13 was enacted as a tax limitation measure. The state dropped from 22nd to 31st in the nation in primary and secondary school expenditures per pupil. Budget pressures meant that teachers who had not specialized in science and mathematics were eliminated, and honors and advanced placement courses were curtailed.[7] The state remains below-average, both in spending per pupil and spending as a percent of personal income of state residents.

Of course the cutbacks stimulated by any cuts in deductibility would differ from state to state. Also, Proposition 13, and the similar Proposition 2 1/2 in

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6 See e.g., Bradbury and Ladd, "Proposition 2 1/2: Initial Impact, Part II," New England Economic Review, March/April 1982, pg. 57; Rothenburg and Smoke, "Early Impacts of Proposition 2 1/2 on the Massachusetts' State-Local Public Sector," Public Budgeting and Financing, Winter 1982, p. 101. See generally, K. Forbis Jordan, "Possible Impact on Education Funding Resulting from the Loss of Deductibility of State and Local Taxes," pp. 6-10, Congressional Research Service, 1985.

7 Catterall and Brizendine, "Proposition 13: Effects on High School Curricula, 1978-83," American Journal of Education, May 1985, pp. 327-351; Terry Schwadron, Editor, California and the American Tax Revolt: Proposition 13 Five Years Later, University of California Press, 1984.

Massachusetts, hit only the local level of government and property taxes. By contrast, eliminating or curtailing income and property tax deductibility would hit the states and localities relying on those taxes. School cutbacks in both California and Massachusetts were buffered by heavy support from state legislatures after the property tax limitations passed; if income and property tax deductibility is curtailed, both levels of government could well be hit at once.

D. The Arbitrary Effects on School Funding

One final inequity deserves mention. As noted above, if the federal government limits income tax deductibility, it will especially hurt one group of states and localities. Yet, if the government limits property tax deductibility, it will hurt another group. The effects will be disproportionately felt in school districts across the country. No curtailment of deductibility -- whether a cap or a floor or some other device -- can avoid harming school systems virtually at random.

Table 6 (p.24-25 above), shows the variation among states (and their local governments) in their reliance on the two kinds of deductible taxes, income and property taxes. States with the highest reliance on income taxes include Delaware (70.9% income versus 29.1% property taxes

-- the two numbers add up to 100%), Alabama (64.9% income taxes), Hawaii (61.1% income taxes), Kentucky (60.5% income taxes) and Maryland (60.1% income taxes).

States with the highest reliance on local property taxes are Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. None of these states has any income tax at all. Curtailing deductibility of income taxes hits education and other services in the former group of states while completely sparing the latter states. This is arbitrary and discriminatory and represents federal education policy at its worst.

The situation is not improved if the federal government targets property tax deductibility as well. Instead, the government then would penalize the poor school districts across the country. Such districts must use high property tax rates to compensate for their low tax bases. Today property tax deductibility helps cushion those disparities and makes the burden of high property taxes easier for taxpayers to bear. Eliminating property tax deductibility would hurt the poor school districts with high tax rates that need it most.

It is not possible to predict the precise impact on each school district of each particular proposal to cut deductibility. State and local tax systems have evolved for

decades on a totally individual basis in reliance on the principle of tax deductibility. There is no justification today for treating some states or localities differently from others solely because of their choice of a particular tax mix. There is no coherent explanation for a federal tax policy imposing its expensive penalties without regard to more rational criteria such as the needs of each state's school system and its fiscal capacity.

V. The Importance of Income Tax Deductibility for Higher Education

Restrictions on income tax deductibility will adversely affect higher education. Table 10, on pp. 40-41, shows how fully one-eighth of state budgets goes to support higher education. Many states spend a much higher proportion, with eight -- Utah (21.7%), Indiana (20.1%), Colorado (19.5%), Nebraska (18.7%), Idaho (18.4%), Alabama (18.3%), Iowa (18.3%), and North Dakota (18.1%) -- allocating over 18% of state budgets.

Restricting income tax deductibility would make higher education vulnerable to budget cuts as a result of taxpayer unhappiness with the consequent increased tax burden from state and local income taxes. Depending on the impact on that particular state's taxpayers, and reactions of those taxpayers, colleges and universities in states spending a large part of their budgets on higher education may be most vulnerable. Also at risk would be colleges and universities, notably in major cities, that are supported by local income tax revenues. Not only state and city colleges and universities would be affected; state spending on higher education also includes scholarship funds and other support for private colleges and universities as well.

States such as Iowa, Colorado, North Dakota, and Nebraska are spending heavily on higher education to help diversify their economies. Southern states are also using higher education to draw high-skill employment to the region. Across the country, states emphasize higher education as the key to vigorous national competition in the international economy. As was true for elementary and secondary schooling, curtailing deductibility now would undercut the effort to improve higher education at just the wrong time.

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